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IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

No. 879

MAGNOLIA PETROLEUM COMPANY, *Petitioner*,

v.

W. A. THOMAS, *Collector of Internal Revenue*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

Your petitioner, MAGNOLIA PETROLEUM COMPANY, a Texas corporation, respectfully prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit, entered December 4, 1945 (R. 35) in a suit there entitled "Magnolia Petroleum Company, a corporation, appellant v. W. A. Thomas, Collector of Internal Revenue, appellee," affirming a judgment of the District Court of the United States for the Northern District of Texas (R. 24-25).

I. SHORT STATEMENT OF THE MATTER INVOLVED.

Magnolia Petroleum Company, a Texas corporation, petitioner, is engaged in the business of producing, refining and marketing crude oil and the products thereof in Texas and other States.

Magnolia Pipe Line Company transports most of petitioner's oil and collects therefor under published tariffs duly filed with the Interstate Commerce Commission and with the proper authorities in the various States concerned. The profit which is realized by Magnolia Pipe Line Company is included in its income and also figures in the valuation of the inventories of the petitioner in so far as it relates to products which have been transported and which remain on hand at the end of the respective taxable periods for which separate returns are filed.

For the year 1933 petitioner, under the provisions of law then in force and as part of an affiliated tax-computing group consisting of Socony-Vacuum Oil Company, Incorporated, Magnolia Pipe Line Company, Vacuum Oil Company, Inc., and others, filed a consolidated income tax return. In this consolidated return the closing inventory of the group did not include transportation costs paid Magnolia Pipe Line Company by petitioner, except to the extent of cost of said transportation to Magnolia Pipe Line Company. The inventory products acquired from Vacuum Oil Company, Inc., were valued at cost to Vacuum not to petitioner. The said consolidated return showed net income of $5,434,888.40, with a resultant income tax of $788,058.82 against which there was claimed credit for foreign taxes paid of $1,800,897.88; there was subsequently filed with the examining agent of the Bureau of Internal Revenue tax receipts and other data supporting foreign tax credit in the amount of $1,725,266.05.

The Revenue Act of 1934 withdrew the privilege of filing consolidated returns and therefore petitioner, for the year 1934, filed its separate return. In this return petitioner set out its opening inventory at a value of $33,637,338.00 and its closing inventory at a value of $39,818,381.13. In valuing the opening and closing inventories for the year 1934 petitioner included the cost to it of transporting the oil and other products included in the inventory, that is, it included in the value of such inventory the amount paid

Magnolia Pipe Line Company for transporting said products.

Likewise, in said inventories, products acquired from an affiliated company, Vacuum Oil Company, Inc., were valued at the cost of these products to petitioner rather than to Vacuum Oil Company, Inc.

In petitioner's separate income tax return for the calendar year 1935 petitioner fixed the value of its opening inventory at $39,818,381.13 and of its closing inventory at $36,643,528.79. In computing the value of its opening and closing inventory for the year 1935, petitioner followed the same procedure at it did for the year 1934 as above set out..

The Internal Revenue Agent reduced petitioner's opening inventory as of January 1, 1934, to the same figure as the closing inventory reported upon the affiliated basis for the calendar year of 1933, thereby decreasing petitioner's opening inventory for 1934 by the sum of $2,536,328.31. Included in this figure is the amount of $2,493,872.31 which is the difference between the amount paid by petitioner to the pipe line company at tariff rates and the cost to the pipe line company of transporting said oil. The balance represents the difference between the cost of goods to petitioner and cost to Vacuum Oil Company, Inc., affecting goods purchased by petitioner from Vacuum Oil Company, Inc. The Agent also decreased the closing inventory as of December 31, 1934, by $344,314.48 to bring the cost of products remaining at that time out of the December 31, 1933, inventory to the same affiliated cost basis. These changes resulted in a total addition of $2,192,013.83 to income for the year 1934. Likewise, the Revenue Agent adjusted the opening inventory for 1935 to the same figure as fixed by him as the closing inventory for 1934, thereby increasing the income for the year 1935 by the sum of $344,314.48. This resulted in the assessment of additional taxes and interest in the sum of $444,180.19, which amount was paid by petitioner (R. 13-16).

The Commissioner did not value the opening inventory for 1934 on the same basis as he used in valuing the closing inventory for that year. This was due to the fact that the opening inventory for 1934 was valued at cost to the affiliated group, of which petitioner was a member, whereas the closing inventory, except for the products remaining out of the opening inventory, was valued on the basis of cost to the petitioner (R. 16). It is agreed that if petitioner was correct in its handling of inventories it should recover the amount sued for and that if the Commissioner was correct, the Collector of Internal Revenue should prevail (R. 18).

II. JURISDICTION.

This court has jurisdiction to review the decision of the United States Circuit Court of Appeals for the Fifth Circuit under the authority of the Act of February 13, 1925; C. 229; 43 Stat. 936, as amended (Section 240 of the Judicial Code, Title 28, Section 347, U. S. C. A.).

The Circuit Court has decided an important question of federal law which has not been but should be settled by this court.

III. OPINION BELOW.

The opinion (R. 31) of the Circuit Court of Appeals is reported in 151 F. (2d) 1008.

IV. QUESTIONS PRESENTED.

What is the proper value of the opening and closing inventories of taxpayer for the years 1934 and 1935?

Petitioner placed crude oil in its inventories for said years at cost to it, including the cost of transportation of said oil by a pipe line at tariff rates actually paid. The Commissioner deducted from the cost of said oil in petitioner's inventories the difference between the amount paid by petitioner to the pipe line company and the cost to the

pipe line company of transporting said oil. The Commissioner accomplished this by using as petitioner's opening inventory in its separate return for 1934 the same value as was used in the closing inventory of 1933, a year in which a consolidated return was filed and in which intercompany profits had been eliminated. The sole question here is whether the Court erred in sustaining the action of the Commissioner in thus deducting from the cost of oil in petitioner's inventories a part of the cost of transporting it. The same question is involved in determining whether the Court erred in sustaining the action of the Commissioner in valuing the products purchased during affiliation by petitioner from Vacuum Oil Company at cost to Vacuum Oil Company rather than at cost to petitioner.

STATUTES AND REGULATIONS INVOLVED.

Applicable statutes and regulations are printed in the Appendix. *Infra*, pp. 7-9.

V. REASONS RELIED ON FOR ALLOWANCE OF WRIT.

The reasons relied on, as more fully presented in the accompanying brief, are:

(1) The Circuit Court has decided an important question of federal law which this Court has not passed on.

(2) This Court should pass on the question for the reason that the Circuit Court has erroneously decided the same, and this Court should review that decision and correctly settle the matter.

(3) Article 113(a)(11)-1 of Regulations 86, claimed to be controlling in this case, has no legal basis in the Revenue Act of 1934 and is void.

(4) The Commissioner has acted arbitrarily and without authority in this case.

(5) The evidence is undisputed that the regulations relied upon by the Commissioner in valuing inventories do

not conform to the best accounting practice in the business of taxpayer and do not most clearly reflect its income.

VI. CONCLUSION.

WHEREFORE, MAGNOLIA PETROLEUM COMPANY, petitioner, through its undersigned attorneys, prays that a writ of certiorari issue directed to the United States Circuit Court of Appeals for the Fifth Circuit, to review the judgment entered on the 4th day of December, 1945 (R. 35) in a suit there entitled "Magnolia Petroleum Company vs. W. A. Thomas, Collector of Internal Revenue," and that upon hearing said judgment be reversed and set aside.

Respectfully submitted,

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APPENDIX.

Statutes and Regulations Involved.

Section 22(c) of the Revenue Act of 1934 reads as follows:

> "(c) *Inventories.* Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming, as nearly as may be, to the best accounting practice in the trade or business and as most clearly reflecting the income."

Section 113(a) (1) of the Revenue Act of 1934 reads as follows:

> "113. *Adjusted Basis for Determining Gain or Loss.*
> "(a) *Basis (Unadjusted) of Property.* The basis of property shall be the cost of such property; except that—
> "(1) *Inventory value.* If the property should have been included in the last inventory, the basis shall be the last inventory value thereof."

Section 113(a)(11) of the Revenue Act of 1934 reads as follows:

> "(11) *Property acquired during affiliation.* In the case of property acquired by a corporation, during a period of affiliation, from a corporation with which it was affiliated, the basis of such property, after such period of affiliation, shall be determined, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, without regard to intercompany transactions in respect of which gain or loss was not recognized. For the purposes of this paragraph, the term 'period of affiliation' means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto) but does not include any taxable year beginning on or after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928.

> The basis in case of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made by such corporation under Section 141 of this Act or the Revenue Act of 1928 or the Revenue Act of 1932, shall be determined in accordance with regulations prescribed under Section 141(b) of this Act or the Revenue Act of 1928 or the Revenue Act of 1932. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made by such corporation under Section 141 of this Act or the Revenue Act of 1928 or the Revenue Act of 1932, shall be adjusted in respect of any items relating to such period, in accordance with regulations prescribed under Section 141(b) of this Act or the Revenue Act of 1928 or the Revenue Act of 1932, applicable to such period."

A portion of Article 113(a)(11)-1 of Regulations 86 relating to the income tax under the Revenue Act of 1934 reads as follows:

> "* * * The basis of property after a consolidated return period shall be the same as immediately prior to the close of such period. This rule is applicable, for instance, to the making of separate returns by the members of an affiliated group of corporations for taxable years beginning after December 31, 1933, due to the withdrawal under the law of the privilege of making consolidated returns. For example, if a corporation has been a member of an affiliated group which has made a consolidated return on the calendar year basis for the taxable year 1933 and is required to make a separate return for the taxable year 1934 and succeeding taxable years, the value of the opening inventory to be used in computing such corporation's net income for the taxable year 1934 is the proper value of the closing inventory used in computing the consolidated net income for the preceding taxable year."

Reg. 86, Art. 22(c)-2, *Valuation of inventories.*— Section 22(c) provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect the income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

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BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

I. OPINION BELOW.

The petition seeks a writ directed to the United States Circuit Court of Appeals for the Fifth Circuit to review a judgment entered by it in a suit there entitled "Magnolia Petroleum Company vs. W. A. Thomas, Collector of Internal Revenue," (R. 35) and reported in 151 F. (2d) 1008.

II. JURISDICTION.

Grounds upon which the jurisdiction of this court is involved have been set forth in the petition. Briefly stated, jurisdiction is based upon the Act of February 13, 1925, C. 229; 43 Stat. 936 as amended (Section 240 of the Judicial Code, Title 28, Section 247, U. S. C. A.).

III. STATEMENT OF THE CASE.

The facts have been stated in the petition. However, additional facts will be set out in the argument as each of the errors is hereinafter discussed.

IV. SPECIFICATIONS OF ERROR.

1. The court erred in sustaining the action of the Commissioner in his manner of valuing the inventories of petitioner for the years 1934 and 1935 because the regulations under which the Commissioner acted are invalid, being without basis in the law.

2. The court erred in sustaining the action of the Commissioner in his manner of valuing the inventories of petitioner for the years 1934 and 1935 because the action of the Commissioner was arbitrary and inconsistent with his treatment of inventories in similar situations both before and after the years in question.

3. The court erred in rendering judgment against the petitioner herein.

V. ARGUMENT.

1. The court erred in sustaining the action of the Commissioner in his manner of valuing the inventories of petitioner for the years 1934 and 1935 because the regulations under which the Commissioner acted are invalid, being without basis in the law.

In explaining how inventories are involved in the determination of income, Mr. Harry Goodson, witness for petitioner, testified:

> "In arriving at income, there is deducted from sales the cost of goods sold. Inventories are factors in the cost of goods sold. For instance, the inventory at the beginning of the year is added to cost of acquiring goods during that year. From that total is deducted the inventory at the end of the year resulting in the cost of goods sold." (R. 19)

When asked what was the effect on income for a year of understating the inventory for the beginning of the year, the witness testified:

> "The result would be an overstatement of income for the year. For example, if the opening inventory was actually $100,000 and it was stated $60,000, there would be an understatement of cost of goods sold to the extent of $40,000, and the resulting overstatement of the income to the extent of $40,000." (R. 19)

It thus appears that the Commissioner by lowering the opening inventory of taxpayer for any year increases the taxable income for that year. The Commissioner following, as he says, Section 113(a)(11)-1 of Regulations 86, reduced the opening inventory of taxpayer for the year 1934 by taking as the opening inventory for that year the closing inventory of the affiliated group for 1933. He eliminated the pipe line company's profit and thereby eliminated a part of the transportation costs of the goods in the inventories as above stated. It is this action of the Commissioner which the petitioner contends is arbitrary. Any regulations that make possible such action on his part are invalid because they exceed the powers of the Commissioner and have no basis in law as will hereinafter be set out.

While considering our discussion of the tax laws hereinafter, we urge the Court to keep in mind these words:

> "It is well established that in case of doubt in the interpretation of statutes levying taxes they should be most strongly construed against the Government and in favor of the citizen. Gould vs. Gould, 245 U. S. 151." *Tulsa Tribune Company vs. Commissioner of Internal Revenue,* 58 Fed. (2d) 937.

Section 22(c) of the Revenue Act of 1934, applicable to this case, reads as follows:

> "(c) *Inventories.* Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such

basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming, as nearly as may be, to the best accounting practice in the trade or business and as most clearly reflecting the income."

The power of the Commissioner is strictly limited by this Act in his treatment of inventories. Among the restrictions are (1) the basis prescribed by the Commissioner must conform, as nearly as may be, to the best accounting practice in the trade or business, and (2) the method used must be one that will most clearly reflect the income of the taxpayer.

The Commissioner and the Secretary of the Treasury must administer the Act in accordance with its terms. Regulations of the Commissioner of Internal Revenue cannot change or alter the positive provisions of the law. In the case of *United States* v. *200 Barrels of Whiskey*, 95 U. S. 571, 576, the Court says:

> "The rules and regulations which the Commissioner of Internal Revenue is authorized by Section 2 to prescribe cannot have the effect of bringing the case under the operation of the penalty provided * * * *the regulations of the department cannot have the effect of amending the law.* They may aid in carrying the law as it exists into execution but they cannot change its positive provisions." (Italics ours)

See also *Merritt* v. *Welsh*, 104 U. S. 694; *Morrill* v. *Jones*, 106 U. S. 466; *Campbell* v. *United States*, 107 U. S. 407; *Anglo-California Bank* v. *Secretary of the Treasury*, 76 Fed. 742, 749; and *United States* v. *Foster*, 211 Fed. 206, where it appears (page 210) that:

> *"Regulations are valid only so far as they accord with, and carry out, and are not inconsistent with Acts of Congress dealing with the same questions."* (Italics ours)

In the case of *Miller* v. *United States*, 294 U. S. 435, Mr. Justice Sutherland said (p. 440):

> "The only authority conferred, or which could be conferred, by the statute is to make regulations to carry out the purpose of the act—*not to amend it.* United States v. 200 Barrels of Whiskey, 95 U. S. 571, 576; Morrill v. Jones, 106 U. S. 466, 467; United States v. Grimaud, 220 U. S. 506, 517; Campbell v. Galeno Chemical Co., 281 U. S. 588, 610." (Italics ours)

See also *Manhattan Co.* v. *Commissioner,* 297 U. S. 129, 134, where appears the latest expression of this Court on the subject (quoted in *Cereal Products Refining Corporation,* 39 B. T. A. 92, 96, hereafter discussed), as follows:

> "The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end *is not the power to make law* —for no such power can be delegated by Congress— but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity. Lynch v. Tilden Produce Co., 265 U. S. 315, 320-322; Miller v. United States, 294 U. S. 435, 439-440, and cases cited. And not only must a regulation, in order to be valid, be consistent with the statute, but it must be reasonable. International Ry. Co. v. Davidson, 257 U. S. 506, 514." (Italics ours)

The above cases set down clearly the principle that the Commissioner must follow the law. He cannot, by regulation, exceed the limited powers granted him by statute. We shall attempt to show that in the instant case the Commissioner acted in a purely arbitrary manner, and that the regulations issued by him under the Revenue Act of 1934 were invalid as they exceeded the powers granted him under said Act.

A.

The regulations of the Commissioner, relied upon by the government (R. 6), do not conform to Section 22(c) of the Revenue Act of 1934, set out above, in that said regula-

tions do not provide for a basis of valuing inventories that conforms to the best accounting practice in the oil business, and the Commissioner, pursuant to said regulations, does not in this case follow the best accounting practice, nor a method most clearly reflecting the income.

Mr. Harry Goodson, the witness, after testifying that he knew what constituted good accounting practice in the oil business, testified as follows:

"By Mr. Myers:

"Q. Now, the question again is, in arriving at net income of a consolidated group, how should the opening inventory and the closing inventory be valued in order to conform to the best accounting practices in the business?

"A. The opening inventories and closing inventories should be valued at the cost to the consolidated group, or cost, or market, whichever basis is being used; that is accomplished by valuing the inventory of each of the individual companies, included in the consolidated group, at both the beginning and the end of the year on the basis stated, and eliminating from the total of such inventory any intercompany profits that might be included in either the beginning or ending inventory.

"Q. Now in arriving at the net income of a separate corporation, how should the opening inventory and the closing inventory be valued in order to conform to the best accounting practice and to most clearly reflect the inventory? (income).

"A. It is cost or market both at the beginning and the end of the year.

"Q. At cost to whom?

"A. Cost to the individual company whose income is being determined.

"Q. In arriving at the income of a consolidated group for the year 1933, the stipulation shows that there was eliminated the sum of $2,493,872.00, the net income earned by Magnolia Pipe Line Company in transporting products included in that inventory of the Magnolia Petroleum Company. In arriving at the net income of the Magnolia Petroleum Company for 1934, if this inventory valuation should be used instead of

the valuation based upon cost of the inventory to Magnolia Petroleum Company, what effect would it have on the net income thus determined?

"A. As I previously testified, in order to arrive at net income of a separate company, as Magnolia Petroleum Company, the inventory should be valued at the beginning of the year, on the same basis as of at the end of the year. If it were valued at an amount less than the opening inventory—valued at an amount less than cost—and the closing inventory was valued at cost, the income of the Magnolia Petroleum Company would be overstated to the extent of such reduction, and the effect would be in this case to impute to Magnolia Petroleum Company for the year 1934, income of $2,493,000.00 or whatever the figure is prior to January 1, 1934." (R. 21-22)

It is apparent from the foregoing testimony that the petitioner, not the Commissioner, used the best accounting practice in handling its inventories for the years 1934 and 1935. This means that Magnolia Petroleum Company must include oil and products in its inventories at their full cost to it, including all of the cost of transportation as fixed by tariffs, and not a portion thereof. This is what petitioner did and it is the only method that correctly values such inventories. As Mr. Goodson testified, an understatement of the inventory for the beginning of the year results in an overstatement of the income for the year. The regulations under Section 22(c) embodied in Article 22(c)(1) to Article 22(c)(8) compel the recognition of all cost factors in preparing inventories at cost or at cost or market whichever is lower. The true income of petitioner for the years 1934 and 1935 could only be obtained by giving the proper value to the opening and closing inventories of taxpayer for those years. The proper valuation of said inventories could not be obtained by deducting a portion of the cost of the goods, that is, a part of the cost of transportation.

B.

The other section of the Revenue Act of 1934 which has to do with inventories is Section 113(a)(1), which reads as follows:

> "The basis of property shall be the cost of such property, except that (1) * * * if the property should have been included in the last inventory the basis shall be the last inventory value thereof."

The last inventory value referred to in the above quoted portion of the law means that *"of the taxpayer"*. The elimination of intercompany profits in the consolidated return was merely for the purpose of computing the tax for the affiliated group. Each of the companies constituting the affiliated group must first determine its own opening and closing inventory based on cost to it. That constitutes inventory value of the company. It is only after these values have been ascertained that intercompany profits are eliminated. Thus, for the year 1933 the inventories of Magnolia Petroleum Company were first determined at cost to it and it is this inventory value which is referred to in the provision of law above quoted. The elimination of intercompany profits under other provisions of the law and regulations does not in any way change the income of this taxpayer. It is only the income of the affiliated group that is determined by eliminating intercompany profits.

This was directly held by the Court of Claims in the case of *Swift & Co.* v. *United States*, 69 Ct. Cls. 171. The court said at page 191:

> *"Moreover, the separate corporations are the taxpayers, and the affiliated group is merely a tax-computing unit, not a taxable unit."* (Italics ours)

This Court explained the purpose of consolidated returns in the case of *Burnet* v. *Aluminum Goods Co.*, 287 U. S. 544, in these words:

> "The purpose of requiring consolidated returns by affiliated corporations was, as the Government con-

> tends, to impose the war profits tax, according to true net income and invested capital of what was, in practical effect, a single business enterprise, even though conducted by means of more than one corporation. Primarily, the consolidated return was to preclude reduction of the total tax payable by the business, viewed as a unit, by redistribution of income or capital among the component corporations by means of intercompany transactions."

The Commissioner and the courts have ruled upon analogous situations in which it is clear that the language used in the taxing statutes referred exclusively to the taxpayer in question and could not be broadened to cover a predecessor, a transferror or an affiliated taxpayer.

For example, in respect to the privilege of deducting depletion on a discovery value, it is held that the discovery must be that of the taxpayer and not of any predecessor organization. *Darby-Lynde* v. *Commissioner*, 51 Fed. (2d) 32, affirming 20 B. T. A. 522; *Hoffer Oil Corporation* v. *Commissioner*, 27 B. T. A. 98; *Rialto Mining Corporation*, 25 B. T. A. 980. The Board of Tax Appeals (now the Tax Court) in the *Hoffer* opinion, referring to the cases of *Darby-Lynde Co.* and *Rialto Mining Corporation*, holds:

> "In both cases the right to depletion on discovery value was denied the petitioner, on the ground that *it was a different legal entity from the actual discoverer, and was not 'the taxpayer,'* to whom, alone, Section 204(c), above cited, grants the controverted right." (Italics ours)

So, also, precisely the same attitude has been taken in respect of net losses permitted by the several Revenue Acts to be carried forward to later years under conditions prescribed by the statutes; it has been consistently held that the loss of one entity may not be availed of by another even though a direct successor in interest. *Weber Flour Mills Co.* v. *Commissioner*, 82 Fed. (2d) 764, affirming 32 B. T. A. 181. In this case the court says:

"It follows that the new corporation is a distinct and separate taxable entity from the old corporation and the trustees for its creditors and stockholders, and the new corporation is not entitled to deduct losses incurred by its predecessors. See New Colonial Ice Co. v. Commissioner, supra; Pennsylvania Co. v. Commissioner, supra; McLaughlin v. Purity Investment Co., supra; Woolford Realty Co. v. Rose, 286 U. S. 319, 52 S. Ct. 568, 76 L. Ed. 1128; Planters' Oil Co. v. Hopkins, 286 U. S. 332, 52 S. Ct. 509, 76 L. Ed. 1135."

In *Woolford Realty Co., Inc.* v. *Rose,* 286 U. S. 319, cited in the *Weber Flour Mills* opinion, net losses prior to affiliation were denied to other members of the group in the consolidated return period. A similar result was reached in *Planters' Cotton Oil Co., Inc.* v. *Hopkins,* 286 U. S. 332, where the losses had been sustained by joint stock associations during the year preceding transfer of the assets to three corporations which thereupon became affiliated and filed a consolidated return for the fiscal year ended June 30, 1925.

The language of this Court in *Woolford Realty Co., supra,* is applicable to the present case:

"The popular or received import of words furnishes the general rule for the interpretation of public laws. Maillard vs. Lawrence, 16 How. 251, 261; Old Colony R. Co. v. Commissioner, 284 U. S. 552, 560 • • • the statute has given notice to the taxpayer that the aggregate of minus quantities is not to be turned over as a credit to an affiliated company, but is to be used in another way. If the loss for the first year is more than the income for the second, the excess is to be carried over to a third year, and deducted from the net income, if any, returnable for that year, at which time the process of carrying over is to end. Cf. report of Senate Committee in charge of the revenue act of 1924, Senate Report No. 398, 68th Congress, 1st Session, p. 20. Obviously, the direction to apply the excess against the income of a later year is inconsistent with a purpose to allow it to an affiliated company as an immediate deduction

from income of the current year. Adherence to the one practice excludes adherence to the other. Cf. Treasury Regulations 69 promulgated under the act of 1926, Arts. 634, 635, 1622. The fact is not to be ignored that each of two or more corporations joining (under sec. 240) in a consolidated return is none the less a taxpayer. Commissioner v. Ginsburg Co., 54 Fed. (2d) 238, 239. By the express terms of the statute (sec. 240b) the tax when computed is to be assessed, in the absence of agreement to the contrary, upon the respective affiliated corporations 'on the basis of the net income properly assignable to each. The term "Taxpayer" means any person subject to a tax imposed by this Act.' Revenue Act of 1922, sec. 2a (9). A corporation does not cease to be such a person by affiliating with another."

Again, in the determination of "gross income from the property" in computing percentage depletion on oil or gas wells for 1930 under Section 114(b) (3) of the 1928 Act, the court recognized this construction of the tax laws when it said in *Crews* v. *Commissioner*, 89 Fed. (2d) 412, 415:

> "It is true that the first sentence of section 114 (b)(3) uses the phrase 'gross income from the property' but we think the phrase 'to the taxpayer' is necessarily implied."

Under these precedents the inventory value to be employed in the instant case is the inventory value of the taxpayer petitioner, Magnolia Petroleum Company, and not of any affiliate or affiliated group. The inventories of Magnolia Petroleum Company, in respect of its products transported by Magnolia Pipe Line Company, included the lawful tariff charge paid to Magnolia Pipe Line Company by petitioner for the transportation in question and, therefore, the profit to the pipe line company was represented in the charge as well as the cost of that transportation to petitioner. Hence, this is the figure which Section 113(a) (1) requires the petitioner to use in determining its gain or loss upon the disposition of these goods. The fact that

consolidated returns had been required or permitted in previous years under prior laws in which the profit on pipe line transportation had been eliminated is beside the issue and does not affect the proposition, so clearly enunciated by this Honorable Court and other tribunals cited above, that these incidents of consolidated accounting do not operate to merge the entities which, on the contrary, remain separate and distinct taxpayers for revenue purposes.

C.

The quoted regulations of the Commissioner and his action in this case violate the fixed tax principle of annual accounting.

In the case of *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, this Court said:

> "All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt."

This doctrine, based on Congressional mandate and the decisions, has been reasserted in the case of *Helvering* v. *Morgan's, Inc.*, 293 U. S. 121, followed in numerous decisions by the lower Federal courts and Tax Court of the United States (formerly the United States Board of Tax Appeals).

The Commissioner seeks to follow the inventoried products from the year 1933 into the year 1934, and to apply one integrated method of taxation to achieve a definite result regardless of the fact that the situation for 1933 had been crystallized, and that returns had been filed for that year, even before the Revenue Act of 1934 was approved on May 10, 1934. This holding of the Commissioner would require Magnolia Petroleum Company to include in its returns for 1934 and 1935 net income earned

by Magnolia Pipe Line Company in 1933 from transporting products remaining in Magnolia Petroleum Company's inventory as of December 31, 1933. This violates the principle of annual accounting for tax purposes which is firmly established in the law. *Lucas* v. *Structural Steel Company*, 281 U. S. 264.

D.

Regulations 86, Article 22(c)-2 is violated by the Commissioner in his handling of petitioner's income for the year 1934 in that the opening and closing inventories for said year are not on the same basis. Items in said inventory acquired by petitioner during the year 1934 are entered in the closing inventory of taxpayer at cost to it, whereas the Commissioner has placed items in the opening inventory of 1934 at cost to the affiliated group of which petitioner was a member. This inconsistency of treatment leads to an absurd result, as illustrated by the following example: For the transportation of one barrel of oil from the Healdton Field, Oklahoma, to Fort Worth, Texas, on December 31, 1933, Magnolia Petroleum Company, we will say, paid the pipe line company 30¢ in accordance with legal tariff rates. The amount of this transportation cost included in Magnolia's inventory on January 1, 1934, by the Commissioner was not 30¢ but 11.18¢ which latter figure was the cost to the transporter. Magnolia Petroleum Company had purchased said oil at $1.00 per barrel, making the total value of said barrel of oil in the inventory on January 1, 1934, $1.1118. Another barrel of oil of the same kind and quality, from the same field, transported on January 1, 1934, has been valued by the Commissioner at $1.30 for inventory purposes, including the transportation cost of 30¢. Thus, two like barrels of oil transported a few hours apart, and costing petitioner the same amount, have a difference in value in the same inventory of 18.82 cents. Consistency, under the cited regulations, requires that the opening and closing inventories in any one year be valued on the same basis. The illustration shows the results of failing to do so.

It follows that petitioner's income is not clearly reflected when inventories are valued in this inconsistent manner.

2. The court erred in sustaining the action of the Commissioner in his manner of valuing the inventories of petitioner for the years 1934 and 1935 because the action of the Commissioner was arbitrary and inconsistent with his treatment of inventories in similar situations both before and after the years in question.

In the case of *Aluminum Company of America* v. *United States*, 67 Fed. (2d) 172 (cert. denied 291 U. S. 666), the Commissioner of Internal Revenue in assessing the income tax for 1918 of the consolidated group disregarded intercompany profits (page 173). In other words, he valued the opening inventory at cost to the affiliated group, the tax-computing unit. It is noted that he did not take as the value of the opening inventory of the group the sum of the closing inventories of the individual companies who had filed separate returns for the previous year. This action is in marked contrast to the action of the Commissioner in the instant case where he takes as the opening inventory of the individual companies the closing inventory of the affiliated group for the previous year.

As regards taxable years beginning after December 31, 1940, the Commissioner has recognized the unsoundness of the method of handling inventories which he had theretofore used. In his latest Consolidated Income Tax Regulations 104, Section 23.39, as amended by Treasury Decision 5127, March 5, 1942, and Treasury Decision 5244, March 13, 1943, the revised and corrected treatment of inventories in situations analogous to the instant one, is as follows:

In Subsection (b) (2) of the cited regulation it is provided:

> "(2) *Consolidated Return After Separate Return by Affiliates.*
>
> "If a corporation which is a member of the affiliated group for the first consolidated return period

was a member of the group in the preceding taxable year, the value of its opening inventory to be used in computing the consolidated net income for the first consolidated return period shall be the proper value of the closing inventory used in computing its net income for the preceding taxable year decreased in the amount of profits or increased in the amount of losses reflected in such inventory which arose in transactions between members of the affiliated group and which have not been realized by the group through final transactions with persons other than members of the group."

Recognizing the unsoundness of eliminating intercompany transactions once more at the beginning of a subsequent separate return period, the Commissioner, in Subsection (b) (3) of said regulation, has expressly provided:

"(3) *Separate Returns Made After Consolidated Returns.*

"If a corporation which was a member of an affiliated group in a consolidated return period makes or is required to make a separate return for the succeeding taxable year, the value of its opening inventory to be used in computing its net income for such succeeding taxable year shall be the proper value of its closing inventory used in computing consolidated net income for the last consolidated return period, increased in the amount of profits or decreased in the amount of losses eliminated in the computation of such inventory as profits or losses arising in transactions between members of the affiliated group, but in an amount not exceeding, in the case of profits, either the amount of profits arising from such intercompany transactions reflected in the closing inventory of such corporation for such succeeding taxable year or the amount of such intercompany profits eliminated from its opening inventory for its first consolidated return period pursuant to the provisions of subparagraph (2) of this subsection, and not exceeding, in the case of losses, either the amount of losses arising from intercompany transactions reflected in the closing inventory for such corporation for such succeeding taxable year or the amount of such intercompany losses eliminated from its opening inventory for its first consolidated

return period pursuant to the provisions of subparagraph (2) of this subsection."

It is apparent that in the *Aluminum Co. of America* case and in the regulations above quoted the treatment of inventories by the Commissioner is the same, that is, the inventories are required to be valued on the basis of the cost to the entity filing the return in order correctly to reflect the income, whereas, the Commissioner in this case has inconsistently, and arbitrarily, taken the opposite position—that the inventories should be valued on the basis of cost to some entity other than the one filing the return.

Just as the proper method of arriving at the taxable income of a group is to value the opening inventory for the year in question at cost to the group, so in the case of determining the taxable income of an individual corporation in any year the opening inventory for that year should be valued at cost to the particular corporation and not at cost to a group with which the individual taxpayer was affiliated in the previous year. See *Aluminum Company of America* v. *United States*, 67 Fed. (2d) 172; *Brownsville Coal & Coke Company* v. *Heiner*, 38 Fed. (2d) 248; *Packard Motor Car Company* v. *United States*, 39 Fed. (2d) 99 (Cert. denied). Any other action by the Commissioner is arbitrary and invalid.

No Income Escapes Taxation.

No income will escape taxation if petitioner is upheld herein. Even if the profit earned by Magnolia Pipe Line Company in 1933 had not been eliminated in the consolidated return there would not have been any tax due by the group for the reason that the foreign credit would have exceeded the tax . (R. 14)

The real effect of the action of the Commissioner in this case is to place upon Magnolia Petroleum Company the burden of paying taxes in 1934 on income earned by Magnolia Pipe Line Company in 1933.

In any event the law should be followed regardless of consequences. Such was the conclusion of the court in *Packard Motor Car Company* v. *United States, supra,* where such action resulted in double taxation.

Eliminating intercompany profits necessarily follows from the use of the consolidated return. The Government considers such elimination as generally a protection or advantage to it. *Burnet* v. *Aluminum Goods Company, supra.* The use of the consolidated return results in disadvantages to the taxpayer as well as advantages. The Commissioner's arbitrary action deprives petitioner of any advantage it might have obtained from the use of such a return after it has suffered the disadvantages incident thereto.

Products Acquired from Vacuum Oil Co.

In determining petitioner's opening inventory for 1934 the Government valued certain products acquired by petitioner from Vacuum Oil Company, Inc., at cost of these products to the Vacuum Oil Company, Inc., rather than at cost to Magnolia Petroleum Company. This incorrect determination, by decreasing said inventory, increased petitioner's income for 1934.

No distinction can be made between the products which are the basis of this adjustment and the products which were owned by petitioner and transported by the pipe line company and the arguments made above are equally applicable here.

VI. CONCLUSION.

The Commissioner erred in excluding from petitioner's opening inventory for 1934 a part of the cost of transporting oil and other products belonging to petitioner. His claimed authority was without basis in the law. Those provisions of the Revenue Act of 1934 applicable to inventories do not authorize his action in this case, because he did not follow the best accounting practice in the busi-

ness and because the basis used by him did not clearly reflect the income of the petitioner for the years in question.

Taxes are assessed on an annual basis, and the income of other taxpayers in other years under other laws should not fix the taxes which this petitioner is to pay for designated years.

We have shown that the Commissioner has acted arbitrarily and without authority in this case and has produced an inequitable and unjust result. The method used by petitioner followed the law and was equitable. The income of a taxpayer in connection with a product cannot be ascertained correctly unless the full cost to the taxpayer of that product has been first determined.

We respectfully urge that the judgment entered by the Court below be reversed.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 879

MAGNOLIA PETROLEUM COMPANY, PETITIONER

v.

W. A. THOMAS, COLLECTOR OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The oral opinion of the District Court is not reported but appears at R. 24–25. The opinion of the Circuit Court of Appeals (R. 31–35) is reported at 151 F. (2d) 1008.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered December 4, 1945. (R. 35.) The petition for a writ of certiorari was filed February 21, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the courts below erred in sustaining the validity of the Treasury Regulation which requires that where a corporate taxpayer was a member of an affiliated group which filed a consolidated return, and in the succeeding taxable year makes a separate return, the value of its opening inventory for computing its net income for the succeeding year shall be the proper value of its closing inventory used in computing consolidated net income for the preceding year.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are set forth in the Appendix, *infra*, pp. 9–18.

STATEMENT

The taxpayer is a Texas corporation engaged in producing, refining and marketing crude oil and the products thereof. (R. 13, 14.) The taxpayer is one of a group of affiliated corporations consisting of Socony-Vacuum Oil Company and its affiliated subsidiaries, and the taxpayer owns all of the capital stock of Magnolia Pipe Line Company, which transports most of the taxpayer's products from its wells to its refineries and in some cases to market. (R. 14.) The taxpayer acquires some of its products from Vacuum Oil Company, Inc., an affiliated company. (R. 15.)

Magnolia Pipe Line Company makes a charge against the taxpayer, in accordance with appro-

priate tariffs, for transporting the taxpayer's products. These charges are entered upon the books of both corporations and settlement is actually made between them. (R. 14.)

For the year 1933 the taxpayer and its affiliates filed a consolidated income tax return under the provisions of law then in force. In accordance with the applicable law and regulations the taxpayer, in computing its inventory of products on hand, did not include transportation costs for those products paid by the taxpayer to Magnolia Pipe Line Company, except to the extent of the cost to Magnolia Pipe Line Company of such transportation; and the inventory products acquired by the taxpayer from Vacuum Oil Company, Inc., were valued at the cost of the products to Vacuum Oil Company, Inc., rather than their cost to the taxpayer. (R. 14–15.) In short, taxpayer's inventory was computed by eliminating as an item of cost the profits to the taxpayer's affiliates.

The Revenue Act of 1934 withdrew from this group the privilege of filing consolidated returns. Accordingly, for the year 1934 the taxpayer filed a separate return. (R. 14–15.) In computing its opening and closing inventory for that return the taxpayer included in the costs of its products the cost to it of transporting the products included in its inventory, that is, the amount paid to Magnolia Pipe Line Company for such transportation; and the taxpayer valued the cost of the products

acquired from Vacuum Oil Company, Inc., at their cost to taxpayer rather than their cost to Vacuum. (R. 15.) In its separate return for 1935 the taxpayer valued its inventories on the same basis as for 1934. (R. 15–16.)

The Commissioner adjusted the taxpayer's opening inventory for 1934 to correspond to the closing inventory for 1933 as it was reported upon the affiliated basis, thereby decreasing the opening inventory for 1934 as valued by the taxpayer, in the amount of $2,536,328.31. He also decreased the closing inventory as of December 31, 1934, by $344,314.48, to bring the cost of products then remaining from the December 31, 1933, inventory to the same affiliated cost basis. These changes resulted in a total addition of $2,192,013.83 to the taxpayer's income for the year 1934. The Commissioner also adjusted the opening inventory for 1935 to correspond to the figure fixed by him as the closing inventory for 1934. (R. 16–17.)

The additional income taxes assessed against the taxpayer for 1934 and 1935, based upon these adjustments, were duly paid by the taxpayer, and the Commissioner denied taxpayer's claims for refund. (R. 17.) The only question in the case is the method of computing the cost of those products in the taxpayer's inventory which the taxpayer had on hand at the opening of 1934, immediately after the taxpayer ceased reporting its income on the affiliated basis, and which remained in taxpayer's inventory through the opening of

1935. (Pet. 4.) The District Court held that the taxpayer is not entitled to recover. (R. 25.) The Circuit Court of Appeals affirmed. (R. 35.)

ARGUMENT

The taxpayer's attack (Pet. 5) upon Treasury Regulations 86, Article 113 (a) (11)–1 (Appendix, *infra,* pp. 15–16), is unjustified. That provision, squarely applicable here, directs that if a corporation has been a member of an affiliated group which has made a consolidated return for 1933, and is required to make a separate return for 1934 and succeeding years, the value of the opening inventory for computing the corporation's net income for 1934 is the proper value of the closing inventory used in computing the consolidated net income for the preceding year. That provision was promulgated under the Revenue Act of 1934, Section 113 (a) (11) (Appendix, *infra,* pp. 12–13), which provides that the cost basis in case of property acquired by a corporation during 1929 or any subsequent year in respect of which a consolidated return is made shall be determined in accordance with regulations prescribed under Section 141 (b) of the Revenue Act of 1928, 1932 or 1934 (Appendix, *infra,* pp. 11, 12). The rule prescribed in the regulation under attack is the same as the rule which was prescribed under the Revenue Acts of 1928 and 1932, in Treasury Regulations 75 and in Treasury Regulations 78. Those Regulations provided

in Article 39 (b) (Appendix, *infra,* p. 15) that if a corporation has been a member of an affiliated group which has filed a consolidated return and in the succeeding taxable year files a separate return, the value of the opening inventory for computing its net income for the succeeding, separate return year shall be the proper value of the closing inventory used in computing consolidated net income for the preceding year. As the court below held (R. 34), the express reference in the 1934 Act to those regulations excludes the contention (Pet. 5) that this same rule, promulgated under the 1934 Act and governing in this case, is without basis in the Revenue Act of 1934.

The taxpayer claims the right to substitute its own method of computation for the method prescribed by the Treasury Regulations and approved by the Revenue Act of 1934, asserting that its own method would more truly reflect the income of the taxpayer itself (Br. 11–21) and would leave untaxed those intercompany profits which previously went unrecognized (Treasury Regulations 78, Art. 31 (a), Appendix, *infra,* p. 14) by virtue of the taxpayer's privilege prior to 1934 of joining in consolidated returns (Br. 21–26). The claim overlooks the general rule that the cost basis of property which should have been included in the last inventory shall be the last inventory value thereof. (Revenue Acts of 1932 and 1934, Sec. 113 (a) (1), Appendix, *infra,* pp. 9, 12.) It

assumes, erroneously, that in speaking of "last inventory value" the statute means something other than the last inventory value used by the taxpayer when it invoked the privilege of joining in a consolidated return. (Br. 17.) Moreover, it assumes that under Section 141 of the Revenue Act of 1932, permitting consolidated returns, all of the profits which went unrecognized during the affiliated return period should necessarily go forever untaxed. Any such assumption is erroneous, for Section 141 (b) gave to the Commissioner a broad discretion to adopt any regulation he may deem necessary for determining and computing the taxes due where consolidated returns were made,

> * * * in order that the tax liability of an affiliated group * * * and of each corporation * * *, both during *and* after the period of affiliation, may be determined * * * in such manner as clearly to reflect the income and to prevent avoidance of tax liability. [Italics supplied.]

The controlling regulation is clearly within the power granted. *Lucas* v. *Structural Steel Co.*, 281 U. S. 264; *Old Mission Co.* v. *Helvering*, 293 U. S. 289.

The case of *Aluminum Company of America* v. *United States*, 67 F. (2d) 172 (C. C. A. 3d), certiorari denied, 291 U. S. 666, stated by the taxpayer to be inconsistent with the Commissioner's

action here (Br. 23) arose under the Revenue Act of 1918, the provisions of which were wholly different from those at bar. Section 23.39 of Treasury Regulations 104 (Appendix, *infra*, pp. 17–18) gives no support to the taxpayer's position. (Br. 23–24.) For years prior to January 1, 1941, those Regulations prescribe the same rule applied by the Commissioner here; and for subsequent years they prescribe a different rule from the one for which the taxpayer contends.

CONCLUSION

The petition presents no substantial question and should be denied.

Respectfully submitted.

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MARCH 1946.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 22. GROSS INCOME.

* * * * *

(c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—

(1) *Inventory value.*—If the property should have been included in the last inventory, the basis shall be the last inventory value thereof.

* * * * *

(12) *Property acquired during affiliation.*—In the case of property acquired by a corporation, during a period of affiliation, from a corporation with which it was affiliated, the basis of such property, after such period of affiliation, shall be determined, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, without regard

to inter-company transactions in respect of which gain or loss was not recognized. For the purposes of this paragraph, the term "period of affiliation" means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto) but does not include any taxable year beginning on or after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928. The basis in case of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made by such corporation under section 141 of this Act or the Revenue Act of 1928, shall be determined in accordance with regulations prescribed under section 141 (b) of this Act or the Revenue Act of 1928. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made by such corporation under section 141 of this Act or the Revenue Act of 1928, shall be adjusted in respect of any items relating to such period, in accordance with regulations prescribed under section 141 (b) of this Act or the Revenue Act of 1928, applicable to such period.

* * * * *

SEC. 141. CONSOLIDATED RETURNS OF CORPORATIONS.

(a) *Privilege to file consolidated returns.*—An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making a consolidated return for the taxable year in lieu of separate returns. The making of a con-

solidated return shall be upon the condition that all the corporations which have been members of the affiliated group at any time during the taxable year for which the return is made consent to all the regulations under subsection (b) (or, in case such regulations are not prescribed prior to the making of the return, then the regulations prescribed under section 141 (b) of the Revenue Act of 1928 in so far as not inconsistent with this Act) prescribed prior to the making of such return; and the making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

(b) *Regulations.*—The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of an affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be determined, computed, assessed, collected, and adjusted in such manner as clearly to reflect the income and to prevent avoidance of tax liability.

(c) *Computation and payment of tax.*—In any case in which a consolidated return is made the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under subsection (b) (or, in case such regulations are not prescribed prior to the making of the return, then the regulations prescribed under section 141 (b) of the Revenue Act of

1928 in so far as not inconsistent with this Act) prescribed prior to the date on which such return is made; except that for the taxable years 1932 and 1933 there shall be added to the rate of tax prescribed by sections 13 (a), 201 (b), and 204 (a), a rate of ¾ of 1 per centum.

Section 113 (a) (12) of the Revenue Act of 1928, c. 852, 45 Stat. 791, is substantially the same as Section 113 (a) (12) of the Revenue Act of 1932, set out above.

Sections 22 (c) and 141 (a) (b) and (c) of the Revenue Act of 1934, c. 277, 48 Stat. 680, are substantially the same as Sections 22 and 141 of the Revenue Act of 1932, set out above.

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property except that—

(1) *Inventory value.*—If the property should have been included in the last inventory, the basis shall be the last inventory value thereof.

* * * * *

(11) *Property acquired during affiliation.*—In the case of property acquired by a corporation, during a period of affiliation, from a corporation with which it was affiliated, the basis of such property, after such period of affiliation, shall be determined, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, without regard to inter-company transactions in respect of

which gain or loss was not recognized. For the purposes of this paragraph, the term "period of affiliation" means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto) but does not include any taxable year beginning on or after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928. The basis in case of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made by such corporation under section 141 of this Act or the Revenue Act of 1928 or the Revenue Act of 1932, shall be determined in accordance with regulations prescribed under section 141 (b) of this Act or the Revenue Act of 1928 or the Revenue Act of 1932. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made by such corporation under section 141 of this Act or the Revenue Act of 1928 or the Revenue Act of 1932, shall be adjusted in respect of any items relating to such period, in accordance with regulations prescribed under section 141 (b) of this Act or the Revenue Act of 1928 or the Revenue Act of 1932, applicable to such period.

* * * * *

Treasury Regulations 78, promulgated under the Revenue Act of 1932.

ART. 12. *Making consolidated return and filing other forms.*

* * * * *

(b) *Authorizations and consents filed by subsidiaries.*

Each subsidiary must prepare two duplicate originals of Form 1122, consenting to these regulations and authorizing the common parent corporation to make a consolidated return on its behalf for the taxable year and authorizing the common parent corporation (or, in the event of its failure, the Commissioner or the collector) to make a consolidated return on its behalf (as long as it remains a member of the group), for each year thereafter for which, under article 11 (a), the making of a consolidated return is required. One of such forms shall be attached to the consolidated return, as a part thereof; and the other shall be filed, at or before the time the consolidated return is filed, in the office of the collector for the district prescribed for the filing of a separate return by such subsidiary. No such consent can be withdrawn or revoked at any time after the consolidated return is filed.

* * * * *

ART. 31. *Consolidated net income.*

(a) *Definition.*

Except as otherwise provided in these regulations, the consolidated net income of an affiliated group, which makes or is required to make a consolidated return for any taxable year, shall be the aggregate of the gross income of each of the members of such group less the aggregate of the allowable deductions of each of such members, except that gain or loss will not be recognized upon transactions between members of the group (referred to in these regulations as "intercompany transactions").

* * * * *

ART. 39. *Inventories.*

* * * * *

(b) *Separate return made after consolidated return.*

If a corporation has been a member of an affiliated group which has made a consolidated return and in the succeeding taxable year makes a separate return, the value of the opening inventory to be used in computing its net income for such succeeding taxable year shall be the proper value of the closing inventory used in computing consolidated net income for the preceding taxable year. For example, corporation S joins in making a consolidated return for 1932 and makes a separate return for 1933. The proper value of its closing inventory for 1932 after eliminating intercompany profits is $90,000. Accordingly its opening inventory for computing its net income for 1933 will be $90,000.

Similar provisions appear in Article 39 (b), of Treasury Regulations 75, promulgated under Section 141 (b), Revenue Act of 1928, applicable to the taxable year 1929, and subsequent taxable years; also in Article 39 (b) of Treasury Regulations 89, promulgated under Section 141 (b) of the Revenue Act of 1934, applicable to the taxable years beginning after December 31, 1933.

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

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ART. 113 (a) (11)–1. *Basis of property acquired during affiliation.*—

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The basis of property acquired by a corporation during any period, in the taxable

year 1929 or any subsequent taxable year, in respect of which a consolidated return was made or was required under Regulations 75, Regulations 78, or Regulations 89, relating to consolidated returns, shall be determined in accordance with such regulations. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made or is required under Regulations 75, Regulations 78, or Regulations 89, shall be adjusted in respect of any items relating to such period in accordance with such regulations.

The basis of property after a consolidated return period shall be the same as immediately prior to the close of such period. This rule is applicable, for instance, to the making of separate returns by the members of an affiliated group of corporations for taxable years beginning after December 31, 1933, due to the withdrawal under the law of the privilege of making consolidated returns. For example, if a corporation has been a member of an affiliated group which has made a consolidated return on the calendar year basis for the taxable year 1933 and is required to make a separate return for the taxable year 1934 and succeeding taxable years, the value of the opening inventory to be used in computing such corporation's net income for the taxable year 1934 is the proper value of the closing inventory used in computing the consolidated net income for the preceding taxable year.

Treasury Regulations 104, promulgated under the Internal Revenue Code, as amended by T. D.

5127, 1942–1 Cum. Bull. 118, and T. D. 5244, 1943 Cum. Bull. 439, 463:

SEC. 23.39. *Inventories.*

(a) *Years Beginning Prior to January 1, 1941.*

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(2) *Separate return made after consolidated return.*

If a corporation has been a member of an affiliated group which has made a consolidated return and in the succeeding taxable year makes a separate return, the value of the opening inventory to be used in computing its net income for such succeeding taxable year shall be the proper value of the closing inventory used in computing consolidated net income for the preceding taxable year. For example, Corporation S joins in making a consolidated return for 1938 and makes a separate return for 1939. The proper value of its closing inventory for 1938 after eliminating intercompany profits is $90,000. Accordingly its opening inventory for computing its net income for 1939 will be $90,000.

(b) *Years beginning after December 31, 1940.*

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(3) *Separate returns made after consolidated returns.*

If a corporation which was a member of an affiliated group in a consolidated return period makes or is required to make a separate return for the succeeding taxable year, the value of its opening inventory to be used in computing its net income for such succeeding taxable year shall be the proper value of its closing inventory used

in computing consolidated net income for the last consolidated return period increased in the amount of profits or decreased in the amount of losses eliminated in the computation of such inventory as profits or losses arising in transactions between members of the affiliated group, but in an amount not exceeding, in the case of profits, either the amount of profits arising from such intercompany transactions reflected in the closing inventory of such corporation for such succeeding taxable year or the amount of such intercompany profits eliminated from its opening inventory for its first consolidated return period pursuant to the provisions of subparagraph (2) of this subsection, and not exceeding, in the case of losses, either the amount of losses arising from intercompany transactions reflected in the closing inventory for such corporation for such succeeding taxable year or the amount of such intercompany losses eliminated from its opening inventory for its first consolidated return period pursuant to the provisions of subparagraph (2) of this subsection.

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